

Message Text

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C O N F I D E N T I A L SECTION 01 OF 02 LONDON 10960

LIMDIS GREENBACK

DEPARTMENT PASS FRB

TREASURY PASS OASIA FOR DONALD E. SYVRUD

E.O. 11652: GDS

TAGS: EFIN, UK

SUBJECT: INTERNAL H.M. TREASURY ESTIMATES OF ECO-
NOMIC TRENDS

SUMMARY: MID-YEAR FORECAST INDICATES HIGHER THAN EXPECTED
GROWTH OF GDP AND MANUFACTURING PRODUCTION OVER ESTIMATES
RELEASED DURING APRIL BUDGET PRESENTATION. CURRENT ACC-
OUNT DEFICIT SHOULD HOLD AT ROUGHLY PROJECTED 1.7 BILLION
POUND LEVEL UNDER WORST ASSUMPTIONS AND COULD IMPROVE.
STRONG EXPORT GROWTH SEEN THROUGH END 1977. IMPORT LEVELS
AND TERMS OF TRADE DEVELOPMENTS ARE MAJOR UNCERTAINTIES.
INFLATION SEEN REMAINING AT 13 TO 14 PERCENT LEVEL FOR
MANY MONTHS WITH UNEMPLOYMENT RISING SLOWLY UP TO ABOUT
1.3 MILLION LEVEL. SEASONALLY ADJUSTED, AND DECLINING
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VERY SLOWLY. INVENTORY BUILD-UP STARTED SOONER THAN EX-

PECTED. DECLINE IN MANUFACTURING INVESTMENT EXPECTED TO STOP IN SECOND HALF 1976 AND SHOW CONTINUING INCREASE DURING 1977. END SUMMARY

1. FINANCIAL ATTACHE HAD LENGTHY CONVERSATION WITH SENIOR FORECASTER IN H.M. TREASURY RESPONSIBLE FOR HALF YEARLY ECONOMETRIC ESTIMATES AND PROJECTIONS CURRENTLY BEING PRODUCED. SOURCE REMARKED THAT CHANCELLOR HEALEY HAD PICKED UP ESTIMATES OF 5 PERCENT GDP GROWTH AND 9 PERCENT INCREASE IN MANUFACTURING PRODUCTION AND CITED THESE PUBLICLY. SOURCE STRESSED HIS EXTREME RELUCTANCE TO DISCUSS THE ESTIMATES, CITING MANY CAVEATS BUT WHEN PRESSED INDICATED A MORE OTIMISTIC GROWTH PICTURE THAN INDICATED IN THE CHANCELLOR'S APRIL BUDGET PROJECTIONS. YEAR ON YEAR 1976 REAL GDP GROWTH COULD BE IN THE 4 PERCENT RANGE. OVER THE NEXT 18 MONTHS; I.E., LAST HALF 1976 AND 1977' GDP GROWTH IS SEEN AT 5 PERCENT AT AN ANNUAL BASIS, WITH MANUFACTURING PRODUCTION GROWING AT 9 PERCENT. HMT HAD BEEN INCORRECT IN ITS ESTIMATES OF INVENTORY TRENDS; DECUMULATION STOPPED AND PICK-UP BEGAN EARLIER THAN FORESEEN; I.E., IN FIRST AND SECOND QUARTERS RATHER THAN LATER IN THE YEAR.

2. CURRENT STIMULUS TO GROWTH COMES FROM EXPORTS AND INVENTORY TURNAROUND, WITH ADDITIONAL SUPPORT LATER THIS YEAR AND NEXT YEAR FROM MANUFACTURING INVESTMENT. GROWTH IN VOLUME OF MANUFACTURING INVESTMENT FROM FOURTH QUARTER 1976 TO FOURTH QUARTER 1977 COULD BE 15 PERCENT. EXPORT VOLUME COULD INCREASE BY 10 PERCENT AT ANNUAL BASIS DURING SECOND HALF 1976 AND IN 1977. OUTLOOK FOR GROWTH OF IMPORT VOLUME MORE PROBLEMATIC, POSSIBLY AS LOW AS 5 TO 6 PERCENT. THUS FAR, GROWTH IN IMPORTS HAS BEEN PRIMARILY IN SEMI-MANUFACTURES RATHER THAN IN CONSUMER GOODS, WITH THE EXCEPTION OF PRIVATE AUTOMOBILES. MAJOR DETERMINENT FOR BALANCE OF TRADE DURING NEXT 18 MONTHS WILL LARGELY BE IMPORT PERFORMANCE. TAKING INTO ACCOUNT COMMODITY PRICE TRENDS AND TERMS OF TRADE. EXISTING ASSUMPTION IN INTERNAL FORECASTS IS THAT CONSTANT EXPORT COMPETITIVENESS IN FOREIGN EXCHANGE MARKETS WILL BE MAINTAINED. DESPITE FALL IN STERLING EXCHANGE RATE, ESTIMATE CONFIDENTIAL

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OF CURRENT ACCOUNT DEFICIT THIS YEAR REMAINS APPROXIMATELY 1.7 BILLION POUNDS WITH POSSIBLY SOME IMPROVEMENT. VERY FAVORABLE CURRENT BALANCE RECORDED IN FIRST QUARTER (I.E., 60 MILLION POUNDS DEFICIT) NOT EXPECTED TO BE REPEATED, WHEREAS SECOND QUARTER CURRENT DEFICIT OF 575 MILLION POUNDS LEVEL EXPECTED TO BE ROUGHLY MAINTAINED DURING REMAINDER OF 1976. NO WORSENING IS EXPECTED NEXT YEAR AND THE OUTCOME COULD BE BETTER. MARGINS OF ERROR

ARE OF COURSE LARGE.

3. CURRENT RATE OF RETAIL PRICE INCREASE; I.E.. 13 TO 14
PERCENT LIKELY TO CONTINUE OR ONLY VERY SLOWLY DECLINE
DURING REMAINDER OF THIS YEAR. FURTHER NOTICEABLE DE-

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C O N F I D E N T I A L SECTION 02 OF 02 LONDON 10960

LIMDIS GREENBACK

CLINES IN INFLATION RATE WILL NOT BE SEEN UNTIL 2ND PHASE
OF INCOMES POLICY BEGINS TO TAKE HOLD. WITH REDUCED WAGE
LEVELS LEADING TO REDUCED PRICE LEVELS. OFFSETTING THIS
WILL BE DECLINE OF STERLING, INCREASED WORLD COMMODITY
PRICES AND RELAXED PRICE CODE PROVISIONS. REAL DISPOSABLE
CONSUMER INCOME WILL CONTINUE TO BE SQUEEZED. SOURCE
ACKNOWLEDGED THAT INCOMES POLICIES IN THE UK HAVE SOME-
TIMES BROKEN DOWN IN THE SECOND STAGE. WITH AN UPTURN IN
THE BUSINESS CYCLE WITH INCREASED ORDERS AND PROFITS AS
WELL AS SQUEEZE ON REAL INCOMES. THE DURABILITY OF THE
INCOMES POLICY STANDS A VERY REAL POSSIBILITY OF BEING
SEVERELY TESTED AT SOME POINT NEXT YEAR. THE LEVEL OF

SAVINGS IS A QUESTION MARK. THE ESTIMATED FALL IN THE SAVINGS RATIO FROM 14 PERCENT IN THE 4TH QUARTER OF 1975 TO 13 PERCENT IN THE 1ST QUARTER OF THIS YEAR HAS BEEN CLOSELY WATCHED: GIVEN TAX CUTS THIS QUARTER. THE SAVINGS RATIO COULD INCREASE AGAIN. IT WILL BE A MAJOR FACTOR IN HELPING TO DETERMINE ECONOMIC ACTIVITY LEVELS DURING REMAINDER OF THE YEAR.

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4. GIVEN ABOVE DEVELOPMENTS, IT IS LOGICAL TO EXPECT A REDUCTION IN INITIALLY FORECAST PUBLIC SECTOR BORROWING REQUIREMENT OF 11.9 BILLION POUNDS. SOURCE WOULD NOT ELABORATE EXCEPT TO SAY THAT IN HIS VIEW, THE INITIAL FORECAST CONTAINED A MARGIN OF ERROR OF 1.5 BILLION POUNDS IN EITHER DIRECTION, AND CURRENT TRENDS WOULD LOGICALLY LEAD ONE TO BELIEVE THAT THE ERROR WAS ON THE HIGH SIDE.

5. THE MOST DISQUIETING ELEMENT IN THE FORECAST IS UNEMPLOYMENT. IT IS EXPECTED TO CONTINUE TO INCREASE ON A SEASONALLY ADJUSTED BASIS FROM THE CURRENT 1.25 MILLION LEVEL TO APPROXIMATELY 1.3 MILLION. IT IS UNLIKELY THAT THE LABOR SHAKEOUT THAT HAS TAKEN PLACE WILL BE SPEEDILY REVERSED. UNEMPLOYMENT LEVELS ARE EXPECTED TO CONTINUE HIGH AND BE ONLY SLOWLY REDUCED THROUGH 1977.

6. SOURCE WOULD NOT COMMENT IN ANY DETAIL ON THE PUBLIC EXPENDITURE CUT EXERCISES CURRENTLY BEING MOUNTED. IT REMAINS TO BE SEEN WHAT THE CHANCELLOR WILL BE ABLE TO BRING OFF. A CABINET MEETING ON THE SUBJECT IS SCHEDULED FOR THURSDAY, JULY 15.

7. SOME LONGER TERM ECONOMIC PROJECTIONS ARE SCHEDULED TO BE GIVEN TO A FORTHCOMING NEDO SESSION: WHETHER OR NOT THEY ARE MADE PUBLIC REMAINS TO BE SEEN AND IN ANY CASE THEY WILL NOT BE TOO REVEALING. AS A RESULT OF PARLIAMENTARY PRESSURE AND DECISIONS ALREADY TAKEN, H.M. TREASURY IS SCHEDULED TO BEGIN MAKING PUBLICLY AVAILABLE LONGER TERM ECONOMIC PROJECTIONS ON A HALF YEARLY BASIS, FROM MID-NOVEMBER. SOURCE SAID AS YET THERE HAVE BEEN NO DECISIONS TAKEN ON SPECIFIC PRESENTATION ASSUMPTIONS AND DETAILS NOR WOULD HE EXPECT THERE WOULD BE FOR SOME MONTHS TO COME.

8. COMMENT: VERY LITTLE OF THE ABOVE IS NEW; WHAT IS SIGNIFICANT IS THAT IT REFLECTS THE MOST RECENT VIEWS OF HMT'S OWN FORECASTERS. WHEREAS HMT DOES SEE SIGNIFICANT ECONOMIC PROGRESS HAVING BEEN MADE AND HAS A FAIRLY OPTIMISTIC VIEW FOR THE REMAINDER OF 1976 IT IS HOPEFUL BUT

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LESS CERTAIN OF DEVELOPMENTS NEXT YEAR. CONSIDERABLE AND GROWING IMPORTANCE IS BEING ATTACHED TO THE BENEFITS OF NORTH SEA OIL. PARTICULARLY IMPORT SUBSTITUTION EFFECTS FROM LATE 1977 ONWARDS, BUT THESE HAVE NOT AS YET BEEN CRANKED INTO A LONGER TERM FORECAST.

9. IN RELATED CONVERSATIONS ON LONGER TERM EXCHANGE RATE POLICY, HM TREASURY OFFICIALS INDICATE A POSITIVE ATTITUDE TOWARDS EXPLORING OORT'S PROPOSALS ON ESTABLISHMENT OF EXCHANGE RATE TARGET ZONES. PROVIDED NO POLITICAL DIFFICULTIES ARE INVOLVED. BY THIS, THEY MEAN PROVIDED UK DOES NOT HAVE TO REENTER THE SNAKE, OR A SIMILAR AGREEMENT. THEY ACKNOWLEDGE THAT TARGET ZONES WOULD IMPLY SOME FORM OF DOLLAR INTERVENTION.

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